

**AGENDA ITEM 3b
INTERNAL AUDIT SUMMARIES
AS OF SEPTEMBER 30, 2010**

Internal Audit Summaries for First Quarter of 2010-11

Review of Internal Use of Retired Annuitants

- **Why Office of Audit Services Performed this Review**

The primary objective of our review was to evaluate the process for monitoring the usage of retired annuitants and to ensure CalPERS' compliance with applicable sections of the California Government Code and Title 2 of the California Code of Regulations.

- **What Office of Audit Services Found**

We found opportunities to strengthen the monitoring of retired annuitants. Specifically, two retired annuitants worked over the 960 hours threshold and were unlawfully employed. In addition, ten out of 11 required self-certification forms tested for unemployment insurance were not on file. We found the overall monitoring process could be enhanced by obtaining summary reports from the State Controller's Office to centrally monitor hours worked. Human Resources Division should also review time reports more closely for overtime pay, valid days within the pay period, and include Human Resource staff initials on the time reports to establish accountability of payroll processing. Finally, the procedures for the hiring of retired annuitants should be finalized.

- **What Office of Audit Services Recommends**

Human Resources Division should reinstate retired annuitants when the number of hours worked exceeds 960 hours in a fiscal year and work with the Benefit Services Division to determine what adjustments, if any, are needed. Human Resources Division should also develop a schedule to obtain summary reports from the State Controller's Office to centrally monitor retired annuitant hours worked. Human Resources Division should implement a closer review of time reports to include adherence to overtime laws, accuracy of valid days within the pay period, and ensure the initials of Human Resources Division staff are on time reports to establish accountability of information entered into the Personnel Information Management System (PIMS) payroll system. In addition, Human Resources Division should retain copies of the self-certification form for unemployment insurance to document compliance with applicable laws and policies. Finally, Human Resources Division should finalize the policies and procedures for the hiring of retired annuitants.

- **Management's Response and Action Plan to Strengthen Controls**

Management concurs with Office of Audit Services' observations and has begun to implement some of the recommendations.

- **Positive Controls Noted**

Overall, we found minimal errors with the majority of time reports reviewed. We found no bona fide separation errors between the retiree's separation date and the employment rehire date. Our sample test for one fiscal year had no data entry discrepancies between the retired annuitant time reports and the State Controller's retired annuitant report. Finally, the policies and procedures for attendance and time reporting and the draft procedures for the hiring of retired annuitants were primarily complete.

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Review of Transition Management

- **Why Office of Audit Services Performed this Review**

The purpose of this audit was to evaluate the internal processes for the transition of funds when an external manager is terminated and another is funded and to determine if the internal procedures are being followed.

- **What Office of Audit Services Found**

Our analysis of the reconciliation sheet for transition funds revealed \$15 million in foreign exchange funds as of April 2010. Investment Office staff asserts that a residual balance of \$5 million is reasonable in the short term, and \$1 to \$2 million is reasonable in the long term. Also, the international equity index fund procedures do not include a threshold or maximum time limits for foreign exchange amounts to remain in the transition account. These procedures also require a monthly review of the transition portfolio. We were unable to confirm that the monthly review was consistently performed for our sample.

- **What Office of Audit Services Recommends**

Investment Office, Global Equity Unit, should add criteria and time limits to the procedures for an acceptable transition portfolio foreign currency residual balance. The Global Equity Unit staff should also clarify the expected frequency of the transition portfolio review in their procedures and maintain documentation to show they have completed the review.

- **Management's Response and Action Plan to Strengthen Controls**

Management concurs with the Office of Audit Services' observations and has begun to implement the recommendations.

- **Positive Controls Noted**

CalPERS Statement of Investment Policy for Plan Level and Asset Class Transition Portfolios (policy) was adopted in December 2009. We reviewed the policy and compared it to industry practice and found it to be consistent. We obtained procedures from the Operations Unit and the Global Equity Unit and compared the procedures to the policy. We found the procedures to be detailed, complete, and consistent with the policy as well as consistent with industry practice. Except for the monthly review, the procedures were followed by the Investment Office, Global Equity Unit and Operations Division staff.

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Review of Cash Management

- **Why Office of Audit Services Performed this Review**

The purpose of this audit was to evaluate the process for projecting cash needs and ensuring adequate liquidity for financial obligations and to assess the controls over the cash management process.

- **What Office of Audit Services Found**

We reviewed a sample of four months of internally prepared month end comparisons of estimated to actual cash amounts and independently performed a comparison which resulted in an average difference of 53 percent in the investment projections and five percent in the Fiscal Services operational projections. The comparisons did not consistently contain explanations for the variances. We also found that although all commitments have been funded, a two-month cash forecast is insufficient planning from a business perspective. Additionally, Fiscal Services relies on the State Street summary report of trades and does not perform a detailed reconciliation of trades prior to approving the daily claim and remittance reports. The Investment Office, Operations Unit's procedures for the daily cash forecasting process includes dividends to be forecasted, but they are no longer included in the forecast. Investment Office, Asset Allocation Unit summarized roles and responsibilities for the monthly cash forecast process, but detailed procedures on how to prepare it and the estimated to actual comparison were not available.

- **What Office of Audit Services Recommends**

Investment Office and Fiscal Services should expand the length of time of the existing two-month forecast to improve cash planning and timing of disbursements. Fiscal Services should continue to research the viability of 100 percent daily reconciliation of investment trades. In the interim, Fiscal Services should maintain a complete exception report to monitor the timeliness of resolution. The Investment Office, Operations Unit should resume forecasting of dividends or revise the cash forecasting procedures. The Investment Office, Asset Allocation Unit should improve the estimated to actual cash comparison process and develop procedures for the comparison and its cash forecasting processes.

- **Management's Response and Action Plan to Strengthen Controls**

Management concurs with the Office of Audit Services' observations and has begun to implement some of the recommendations.

- **Positive Controls Noted**

The CalPERS Fund (SJ10) daily cash forecasting and reconciliation procedures we reviewed were primarily complete, and were followed by Investment Office and Fiscal Services staff. Fiscal Services also provided procedures for the two-month cash forecasting process and we found them to be complete and followed as written. Overall, the Investment Office's weekly estimated asset allocation reports indicate adherence to the asset allocation policy for cash.

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Review of the Centralized Collections Unit

- **Why Office of Audit Services Performed this Review**

The primary objective of our review was to assess the controls over collection and reporting of delinquent accounts receivables.

- **What Office of Audit Services Found**

Our review revealed that collection procedures for payment options under certain circumstances do not require staff to maintain formal documentation of approved payment plans or temporary deferrals due to financial hardship. In addition, although Centralized Collections Unit has specific procedures to guide staff on how to process non-compliant cases, we noted procedures do not specify when delinquent accounts should be referred to the Franchise Tax Board Collections Program, Actuarial and Employer Services Branch, or Legal Office for resolution.

Although Centralized Collections Unit accurately reports to management and the Finance Committee delinquent receivable information, we identified controls over reporting that could be strengthened to indicate the divisions or units responsible for collection of delinquent receivables. We also noted reconciliations could be enhanced by ensuring they are performed more timely.

- **What Office of Audit Services Recommends**

Centralized Collection Unit should enhance current procedures to require formal documentation of approved payment plans or temporary deferrals for financial hardship and to specify the criteria required to refer delinquent accounts to the Franchise Tax Board, Actuarial and Employer Services Branch, or Legal Office for resolution.

To enhance transparency of the Quarterly Delinquency Reports, Centralized Collections Unit should identify those delinquent receivables amounts under its responsibility and specify divisions responsible for the remaining delinquent amounts. In addition, Fiscal Services Division should prepare reconciliations for receivables more timely.

- **Management's Response and Action Plan to Strengthen Controls**

Management concurs with the Office of Audit Services' observations and has begun to implement some of the recommendations.

- **Positive Controls Noted**

Policies and procedures exist to govern the collection and discharge of delinquent accounts receivable under the Centralized Collections Unit responsibility. The Centralized Collections Unit provides adequate monitoring over delinquent accounts under their responsibility and accurately reports to management and the Finance Committee delinquent receivables information. Additionally, the Fiscal Services Division appropriately records and reconciles delinquent accounts receivables.

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Internal Domestic Fixed Income Program

- **Why Office of Audit Services Performed This Review**

The review was co-sourced with Macias Gini & O'Connell LLP (MGO). The primary objectives were to review the Internal Domestic Fixed Income Program's compliance with Board-directed policies, compliance rules within the BlackRock system, and to determine whether system access controls are commensurate with current job responsibilities.

- **What Office of Audit Services Found**

MGO performed the agreed-upon procedures and found Fixed Income Unit does not have a formal written manual of the operating procedures and policies. In the Aladdin system, new user and permission access setup for the front office staff does not go through the Office of Enterprise Compliance for secondary review and approval. In addition, of the 20 users tested, eight instances were found in which the Aladdin User Request Form (the Form) was not completed. Without the Form, there is risk that users' access is not commensurate with their current job titles and responsibilities. Also, current policy does not identify the maximum trade amount investment staff can execute. Furthermore, Fixed Income investment officers and portfolio managers may conduct business with any licensed broker-dealers and there are no formalized agreements between CalPERS and broker-dealers.

- **What Office of Audit Services Recommends**

Fixed Income Unit should develop a formal written procedure manual. The Office of Enterprise Compliance should perform a secondary independent review and approval of all user request forms prior to user access set up within the Aladdin system. In addition, the Office of Enterprise Compliance should work in conjunction with the Fixed Income Unit and the BlackRock consultant to perform a complete review of all current users to ensure that only authorized users have access to the system and users' access is commensurate with current job titles and responsibilities. Trade limits, in dollar amounts or as a percentage of the certain portfolio, should be set based on the investment staff's job title. Finally, the Fixed Income Unit should implement a process to vet broker-dealers and maintain a pool of authorized broker-dealers with whom CalPERS investment officers can execute trades.

- **Management's Response and Action Plan to Strengthen Controls**

Management of Fixed Income Unit and the Office of Enterprise Compliance concurs and has begun to implement some the recommendations.

- **Positive Controls Noted**

Overall, the internal control processes utilized by the primary groups who are responsible for performing the internal domestic fixed income investment activities are in compliance with the Board-directed policy. The processes for trade authorization, confirmation, failed trade monitoring, investment valuation and portfolio reconciliation are found to be adequate.